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IRS' Budget Request for Fiscal Year 1992 and Status of the 1991 Tax Return Filing Season

Statement of
Jennie S. Stathis, Director,
Tax Policy and Administration Issues

Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

GAO

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The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Internal Revenue Service's program for detecting and pursuing individuals who have an income of over $100,000 and who fail to file required federal tax returns. It shows that the Service needs to improve this program to make sure that the nation's voluntary tax assessment system remains strong.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from the date of issuance. At that time we will send copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

Major contributors to this report are listed in appendix III. If you have any questions, please call me on (202) 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director
Tax Policy and
Administration Issues

Executive Summary

Purpose

The Internal Revenue Service (IRS) estimates that $7 billion in 1987 federal taxes were not paid because people did not file required income tax returns. IRS identified over 4 million potential individual nonfilers in 1987, which was the most recent year being investigated when GAO did its review. This number represents a 24-percent increase in the number of potential nonfilers since 1985. The 1987 nonfilers included about 40,000 whose annual income exceeded $100,000; these are high-income nonfilers.

The Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, expressed concern about IRS not pursuing high-income nonfilers. He asked GAO to determine whether IRS could investigate more of them and do so more effectively.

Background

IRS identifies potential nonfilers when a tax return cannot be found for income reported on information returns, such as wage statements (Form W-2). IRS assigns cases a priority—based on the estimated tax yield—that determines the degree of IRS scrutiny.

IRS uses three stages to investigate nonfilers. First, IRS sends as many as four notices that ask nonfilers to file a return. Second, IRS sends unresolved cases—depending on amounts and types of income—to either (1) an automated call site, where a tax examiner tries to obtain a tax return, or (2) the Substitute for Return program, where IRS estimates taxes owed, prepares a "substitute" return for the delinquent one, and recommends a tax assessment. In the third stage, cases unresolved at automated call sites are referred to an IRS district. In the Automated Collection System and the district offices, IRS may not pursue a case with a low priority. Rather, IRS may investigate other cases, such as those on delinquent taxes owed by businesses or individuals, that have higher priorities.

To determine whether changing IRS' three-stage process would produce more returns and taxes, GAO randomly selected 1,200 of 3,600 high-income nonfiler cases at three IRS service centers. The 3,600 cases were those still unresolved after two notices were sent to a universe of about 12,000 cases. Of the 1,200 sample cases, GAO asked IRS to experiment by sending about

- 300 directly to District revenue officers,
- 300 to Automated Collection System sites, and

- 300 to the Substitute for Returns program.

The final group of 300 was used as a control and investigated using the normal three-stage process.

Results in Brief

IRS does not fully investigate high-income nonfilers, which creates an ironic imbalance. Unlike lower income nonfilers in the Substitute for Returns program, high-income nonfilers who do not respond to IRS' notices are not investigated or assessed taxes. Even if high-income nonfilers eventually file tax returns, their returns receive less scrutiny than those who file returns on time.

GAO estimates that half of the high-income nonfilers at the three service centers were not investigated by district revenue officers or assessed a tax in earlier stages. Revenue officers did not pursue them because IRS understated the estimated yields from investigating them. Even if IRS correctly estimated these yields, it had too few revenue officers to investigate many more cases.

IRS could investigate more high-income nonfilers by using the Substitute for Returns program. GAO's test showed that this method produced more yield at the lowest cost and created a tax assessment that otherwise was unlikely. GAO believes an assessment, even if understated, is better than letting the nonfiler escape a revenue officer's scrutiny.

Although IRS checks returns filed on time for noncompliance, it does not have a systematic way to check for underreported income or overstated deductions on delinquent returns that high-income nonfilers eventually file. GAO found that none of these delinquent returns were computer matched with information returns, and few returns were referred to the Examination Division to be checked. However, nearly half of the delinquent returns that GAO asked IRS to check had evidence of noncompliance.

Principal Findings

IRS Understates the Priority of High-Income Cases

Two years after the deadline for filing returns, 47 percent of the 3,600 cases had not been investigated by revenue officers or otherwise assessed a tax.[1] Since IRS gave a high enough priority to only 2 percent of the cases, 45 percent will continue to escape revenue officers' scrutiny. This situation occurs partly because IRS' formula for ranking cases to be investigated by revenue officers understates the revenue potential of high-income cases. (See pp. 14 and 15.)

IRS based its formula for ranking cases on tax yields from 1984 nonfiler cases at all income levels, not just those over $100,000. As a result, tax yields for lower income nonfilers pulled down the estimated yield for high-income nonfilers. GAO found that IRS' estimated yields for high-income cases were about one-third of the actual average yield—$2,967 versus $7,811. Had IRS separately estimated yields for high-income cases at the three service centers, revenue officers would have been assigned 831 more cases to investigate at 1989 staff levels, resulting in an additional $10 million in taxes. (See pp. 15 and 16.)

To pursue more high-income cases, IRS would need additional staff. If IRS separately estimated yields for high-income cases and sent them directly to revenue officers, at 1989 staff levels, many cases would not be investigated because other Collection cases have higher estimated yields. (See pp. 16 and 17.)

The Substitute for Returns Program: A Viable Alternative

Given IRS' limited revenue officer staff, GAO tested the potential of referring high-income nonfiler cases to the Substitute for Returns program. By analyzing sample cases, GAO found that referring high-income cases to the program produced a higher yield-to-cost ratio than the current process—$1,716:$1 versus $60:$1. (See p. 17.)

IRS does not include high-income cases in the program because IRS said it believes its substitute return may understate taxes owed. The program uses information returns that may not show all the nonfiler's income. GAO believes, however, that the alternative is worse—high-income nonfilers escape any IRS tax assessment. Including them in the program

[1] All numbers and percents cited are estimates based on sample results unless otherwise indicated.

will help assure that more wealthy nonfilers pay their taxes. (See pp. 17 to 19.)

Delinquent Returns Receive Less Scrutiny Than Those Filed Timely

Nearly 12 years after GAO recommended that IRS check delinquent returns for unreported income, IRS still does not do so. Unlike returns filed on time, delinquent returns from high-income nonfilers are not computer matched for unreported income and are not generally selected for intensive examinations. Nor do IRS staff routinely review delinquent returns for noncompliance. (See pp. 21 and 22.)

GAO found that IRS needs to check such delinquent returns for noncompliance. Nearly half of the 178 delinquent returns GAO asked Examination officials to check had evidence of noncompliance—21 with unreported income and 60 with overstated deductions. However, Collection staff referred only four of these returns to Examination. Conversely, delinquent returns from lower income nonfilers in the Substitute for Returns program are reviewed for noncompliance. (See pp. 22 and 23.)

Recommendations

To improve IRS' pursuit of high-income nonfiler cases, GAO recommends that the Commissioner of Internal Revenue

- separately estimate tax yields for high-income nonfiler cases so more of these cases will be investigated by revenue officers,
- modify the Substitute for Return program to include high-income nonfiler cases that would otherwise escape IRS action, and
- develop a system to check delinquent returns from high-income nonfilers for noncompliance.

Agency Comments

In comments on a draft of this report, the Commissioner of Internal Revenue said that IRS could do more to resolve high-income nonfiler cases. He agreed to separately estimate tax yields and to check delinquent returns for noncompliance. Rather than include high-income cases in the Substitute for Return program, however, he plans to refer them to the Examination Division. GAO did not test this option but believes the concept may provide a workable alternative. (See app. III.)

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Abbreviations

ACS	Automated Collection System
IRS	Internal Revenue Service
RWMS	Resource and Workload Management System
SFR	Substitute for Return
TDI	Taxpayer Delinquency Investigation

Introduction

Our tax system relies on taxpayers to voluntarily assess their tax liability, file returns, and pay taxes on time. Without voluntary compliance, IRS cannot administer the nation's tax laws.

Section 6012 of the Internal Revenue Code requires individuals to file tax returns if they meet certain gross income criteria, regardless of whether they owe taxes. People who do not voluntarily file a return—nonfilers—diminish the public's respect for our tax system. Moreover, nonfiling is unfair to honest taxpayers who must bear a larger share of the tax burden.

Detecting and pursuing nonfilers is important. Unlike those who underreport income or overstate deductions and credits, the nonfiler does not come under the scrutiny of an IRS examiner. A filed return can be checked for errors, omissions, or fraud, but a nonfiler gives no such leads. This report examines IRS' efforts to identify and pursue individual nonfilers with income over $100,000—high-income nonfilers.

In recent years, individuals have voluntarily filed over 100 million income tax returns annually. However, IRS annually identifies a few million individuals who may not have voluntarily filed required returns. IRS estimates that such individual nonfilers caused over $7 billion in 1987 tax losses. This amount represents 11 percent of the estimated $64 billion gap between income taxes owed and voluntarily paid by individuals for 1987.

Taxpayer Delinquency Investigation Program

IRS' Collection Division has principal responsibility for enforcing the highest degree of compliance with the filing requirements of the Internal Revenue Code. As part of its enforcement strategy, Collection also attempts to identify the reasons for nonfiling and ways to prevent it. One of Collection's key programs to obtain delinquent returns is the Taxpayer Delinquency Investigation (TDI) program, which covers both individual and business nonfilers. In addition, Collection staff pursue businesses and individuals who filed returns but owe additional taxes—accounts receivable—through the Taxpayer Delinquent Accounts program.

The TDI program identifies potential nonfiler cases by matching taxpayers' returns with information returns that show taxpayers' income. These information returns are submitted by employers and payers of income, such as banks paying interest. In 1989, payers submitted almost 1 billion information returns to report certain deductions and nearly every category of income, including wages, interest, and dividends. When the match—done by IRS' Martinsburg Computing Center—shows income but no corresponding tax return, a potential nonfiler case is created. Similarly, when the match shows a filed return but not all of the income on the information return, a potential underreporter case is created.

For tax year 1987, such matching has identified about 24 million potential nonfiler and underreporter cases. IRS also identifies potential nonfiler cases by checking its master file for individuals who had filed returns but then stopped filing. IRS does not pursue all identified cases because some have little potential for tax assessments while others have incomplete information on the potential nonfilers.

Tax year 1985 is the most recent year for which IRS has nearly complete results from its efforts to pursue nonfilers. For that year, IRS identified 3.4 million potential nonfilers and spent about $63 million to investigate them. The investigations resulted in obtaining 1.1 million delinquent returns and $1.3 billion in additional tax assessments, interest, and penalties. For 1985, unlike 1987, IRS had not broken out the data by income ranges—that is, low, medium, and high income. Therefore, IRS cannot yet determine its success in obtaining returns from low-income or high-income nonfilers.

For tax year 1987, IRS identified about 4.2 million potential nonfilers. For the reasons discussed above, IRS either did not investigate or merely sent a reminder to file a return to about 2.4 million. The other 1.8 million cases were sent to IRS' service centers for investigation. Almost 40,000 of these 1987 nonfilers had high income—that is, over $100,000—reported on information returns. For tax year 1988, IRS has identified 7 percent more potential nonfilers (about 4.5 million) and 18 percent more with high income (about 47,000) compared to 1987.

IRS Process for Investigating Individual Nonfiler Cases

The initial computer match between information returns and tax returns occurs in December of the year returns are due. IRS makes additional nonfiler computer matches in March and June of the following year to account for those who filed too late to be part of the earlier matches. For tax year 1987, the initial matches were made in December 1988, with the additional matches occurring in March and June 1989.

After identifying potential nonfilers, IRS attempts to obtain delinquent returns using a three-stage process. In the first stage, the appropriate IRS service center sends as many as four computer generated delinquency notices to nonfilers. After each notice, the nonfiler has 6 to 8 weeks to either file a return or explain the reasons for not filing. Service centers began sending delinquency notices for tax year 1987 in June 1989. The final notices were mailed in December 1990.

In the second stage/nonfiler cases that are not resolved during the notice process are assigned to either the Substitute for Return (SFR) program or Automated Collection System (ACS) sites. This decision depends on the amount and type of income involved.

Substitute for Return Program

The SFR program is authorized under Section 6020 of the Internal Revenue Code. It authorizes the Secretary of the Treasury or his delegate to prepare tax returns for persons who file a false or fraudulent return or fail to file a return. The IRS-prepared return "substitutes" for the return that the taxpayer should have filed voluntarily.

In preparing a substitute return, IRS estimates the assessed tax by using its information on the nonfiler, including income shown on information returns. IRS assumes the nonfiler is single and uses the standard deduction. Then, over 2 years, IRS sends up to six notices to the nonfiler. The last two notices show estimated taxes, penalties, and interest owed. If the nonfiler fails to file, IRS assesses the taxes owed and begins efforts to collect them.

Nonfiler cases are eligible for SFR if (1) total income is under $100,000; (2) less than 30 percent of total income is nonemployee compensation—or payments to self-employed individuals; and (3) total income is reported on fewer than 40 information returns. For tax year 1987, almost 1 million of the 1.8 million nonfilers investigated were included in the SFR program.

IRS excludes cases with more than $100,000 in income from SFR because it believes that these cases may be too complex for IRS to prepare a substitute return. IRS excludes cases with over 30 percent nonemployee compensation or over 40 information returns because it believes these nonfilers may have much more income than shown on information returns. IRS is concerned that substitute returns may understate taxes owed.

Automated Collection System Sites

Also in the second stage, IRS refers cases not eligible for SFR, such as high-income nonfilers, to 1 of 21 ACS sites. Each site is a Collection office that attempts to resolve nonfiler cases through phone calls and correspondence. Before doing so, IRS computes a score of the estimated net tax yield, which is the tax owed less investigation costs, for each nonfiler case.[1] Net tax yield is Collection's measure for establishing priorities among its cases, including tax delinquent account cases for which IRS has already assessed a tax. IRS uses the estimated yield at ACS sites and district offices to determine investigative priorities.

For those nonfiler cases that have a high estimated net tax yield compared to other collection cases, ACS tax examiners attempt to identify the nonfiler's address and telephone number. If this information is obtained, the examiner attempts to contact the nonfiler by telephone or letter to secure all delinquent returns. Nonfiler cases that have a lower yield can remain inactive indefinitely in the ACS inventory. IRS did not have data to show the average age of nonfiler cases in the ACS inventory, but many have been unworked for a couple of years. For example, we found nonfiler cases that had been in this inventory since 1988.

District Revenue Officers

During the third stage, unresolved nonfiler cases from ACS are transferred to an automated inventory at the district office called the "queue" where—depending on the estimated net yield—they may be assigned to a revenue officer. If the case is investigated, a revenue officer contacts the person through telephone calls, letters, or visits to obtain the delinquent return. IRS did not have data to show the average age of cases in the queue. However, we found nonfiler cases in the queue from tax year 1980 that may never be investigated because of their low estimated yield.

Who Were the High-Income Nonfilers in 1987?

To determine their demographic characteristics, we analyzed 295 randomly selected cases on high-income nonfilers for tax year 1987 from a total of 3,651 cases at three IRS service centers. Using IRS' data, such as that from information returns, we estimate that

- their median income was $134,000 and consisted primarily of wages,
- their average age was 46,
- 67 percent filed jointly, and

[1] This score is called the Resource and Workload Management System (RWMS) score. IRS estimates it using the average yield of all closed cases. This report refers to the RWMS score as "net yield."

- 89 percent did not file a return for 2 or more years.

We also estimate that 34 percent were due refunds that averaged $7,000. This percentage is lower than for people who filed timely 1987 returns—75 percent were due refunds. Appendix II has additional details on the characteristics of the high-income nonfilers.

Objectives, Scope, and Methodology

In a January 23, 1990, letter, the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, asked us to determine ways IRS could investigate more high-income nonfilers and do so more effectively. We also attempted to develop information to profile the characteristics of high-income nonfilers to see who made up this population.

To meet our objectives, we reviewed IRS procedures used at ACS sites, at district offices, and in the SFR program at service centers. We also discussed the policies, procedures, and priorities of the nonfiler program with officials at the IRS national office.

We also randomly selected a sample of tax year 1987 high-income nonfiler cases at three service centers and asked IRS to investigate them using different methods. We focused on tax year 1987 because, when we selected our sample, it was the most current year that IRS was investigating. We selected the three service centers on the basis of their geographic dispersion and the availability of our staff. IRS officials said the procedures to investigate nonfilers at these three service centers are typical of those at others. (See app. I for detailed information on sample selection and statistical analysis methods.)

For tax year 1987, IRS sent a total of 12,121 potential high-income nonfiler cases to its service centers in Austin, Texas; Cincinnati, Ohio; and Fresno, California. This number represents about 30 percent of the approximately 40,000 high-income nonfiler cases identified nationwide. Of the 12,121 cases, IRS resolved 8,470 (70 percent). IRS did not yet have data to specifically show how often it resolved the cases by obtaining a return in the notice stage or determining that no return delinquency existed. Such data will not be available until late 1991 or early 1992. The remaining 3,651 cases remained unresolved after IRS had mailed two delinquency notices to the nonfilers. We randomly selected 1,200 of these cases.

To test the effectiveness of different collection techniques, we randomly assigned the sample of 1,200 cases into four groups of about 300 each. We assigned one group each to ACS, the SFR program, and revenue officers for investigation. Cases in the three test groups were not sent a third or fourth delinquency notice. The remaining cases served as a control group and continued through IRS' three-stage process.

We developed a data collection instrument that IRS staff used to document their investigations of cases in the four groups. In estimating additional tax revenues, we considered net yield to be the taxes, penalties, and interest owed by the high-income nonfiler for tax year 1987 after subtracting withholding and estimated tax payments made before contact by IRS. The net yield, therefore, represents the increased revenues IRS could obtain from these nonfilers at the three service centers, less any IRS cost. We developed these costs by analyzing IRS' data, which we did not verify, on various Collection tasks. We also identified total revenues IRS obtained for other tax years by pursuing the 1987 cases. This total for all tax years is referred to as net balance due.

During our analysis, we noted that some delinquent returns that Collection staff obtained from high-income nonfilers appeared to underreport income or overstate deductions but were not referred to Examination to be checked for noncompliance. As a result, we asked Examination officials to review the returns received as of March 30, 1990, to determine whether Collection employees should have referred them to Examination. We verified the results of their reviews. We also followed up on our recommendation on this issue from our 1979 report on IRS' nonfiler program.[2]

To develop the profile of high-income nonfilers, we used IRS' data, which we did not verify, from information returns, nonfiler notices, and Master File transcripts for nonfilers in our control group. We also obtained data from any returns that high-income nonfilers eventually filed. We limited our analysis to the control group to reduce the time and effort needed by IRS staff to complete our data collection instrument.

Our audit work was done from October 1989 to September 1990 in accordance with generally accepted government auditing standards.

[2] Who's Not Filing Income Tax Returns? IRS Needs Better Ways to Find Them and Collect Their Taxes (GGD-79-69, July 11, 1979).

Better Results Are Possible If IRS Changes Methods Used to Pursue High-Income Nonfilers

IRS has an ironic imbalance in its nonfiler enforcement program. Unlike lower-income nonfilers in the SFR program, high-income nonfilers who do not respond to IRS actions are not assessed a tax. Instead, ACS employees pursue high-income cases and refer those unresolved to revenue officers. However, very few of these cases are likely to be investigated by revenue officers or assessed a tax, partly because IRS' formula for ranking cases to be investigated understates their estimated yields.

Even if the yields for the 1987 high-income cases had been correctly estimated, IRS staffing would have been insufficient to permit revenue officers to investigate many of the cases. IRS could give more scrutiny to high-income nonfiler cases by including them in the SFR program as is done for low-income nonfilers. This program would provide an assessment against nonfilers who would otherwise escape a revenue officer's scrutiny.

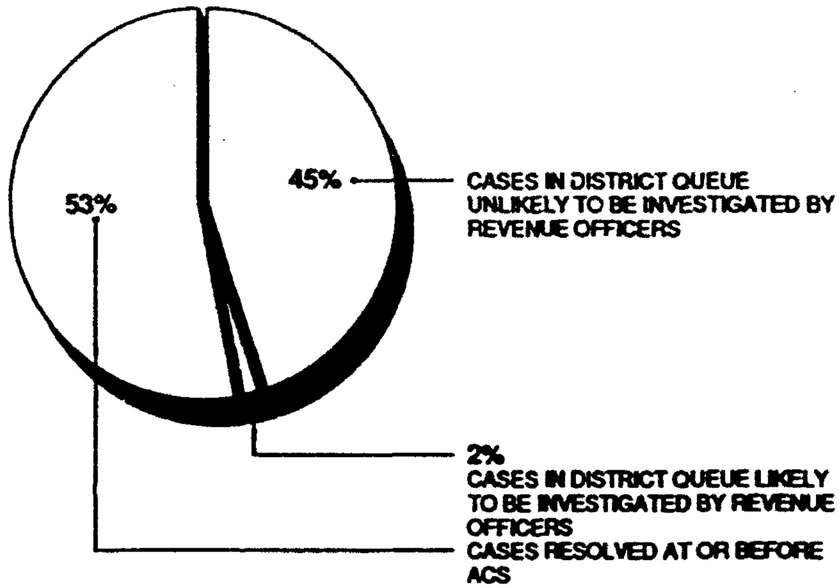
Understated Yields Result in Cases Not Being Worked by Revenue Officers

Two years after the April 1988 deadline for filing returns, 47 percent[1] of the 3,651 high-income nonfilers[2] had not been investigated by revenue officers or assessed a tax. Figure 2.1 shows the April 1990 status of all the cases and the likelihood that unresolved cases eventually will be investigated.

[1] All numbers and percents cited in this chapter are estimates, unless otherwise indicated, based on our sample results.

[2] This number represents the universe of cases at the three service centers in which the high-income nonfilers did not respond to the first two notices.

Figure 2.1: Outcomes for the 3,651 High-Income Nonfiler Cases for Tax Year 1987, as of April 1990



Even with more time, only 2 percent of the cases that were in the district queue had high enough estimated net yields to be investigated by revenue officers. The other 45 percent had low yields, which means that these cases will remain in the queue indefinitely, thus escaping IRS scrutiny.

IRS' estimates of the net tax yields from investigating high-income nonfiler cases were significantly lower than actual yields. This difference occurred because IRS did not separately calculate yields for high-income cases. Rather, IRS estimated 1987 net yields using actual taxes assessed from investigations of all tax year 1984 nonfiler cases. By averaging yields from all cases, those with lower incomes reduced the estimated net yield—and investigative priority—for high-income cases. As a result, IRS' estimated yields for high-income nonfiler cases in our sample were about one-third of the actual yield—$2,967 versus $7,811.

Because 45 percent of 3,651 cases had priorities too low to be investigated by revenue officers, we wanted to determine whether revenue officers would have investigated more cases had IRS not underestimated the yields. To do this, we calculated yields from our sample cases and compared the new yields to the minimum estimated yields necessary to trigger a revenue officer investigation in each district we reviewed. Districts adjust their minimum yields to fit their existing case workload and available revenue officers

This comparison showed that an additional 831 (23 percent) of the 3,651 cases would have exceeded the minimum required for assignment to a revenue officer. These 831 cases represent almost $10 million in additional taxes. Had more revenue officers been available in these districts, the minimum yields to trigger an investigation would have been lower. Thus, more than 831 high-income cases could have been assigned to revenue officers.

IRS Should Consider Alternatives to Its Investigation Methods

To test alternatives for investigating the 3,651 high-income nonfilers, we randomly assigned about 300 cases to each of three groups: (1) revenue officers, (2) ACS tax examiners, and (3) tax examiners at the SFR program. Another 300 cases were randomly assigned to a control group and were investigated using IRS' current three-stage method.

Each alternative approach resulted in a higher proportion of delinquent returns being obtained and in higher average yields than IRS' current approach. The most successful, however, varied depending on the criteria used to measure success. When the highest rate of obtaining delinquent returns is the primary measure, the revenue officers were the most successful. Conversely, when the highest yield or yield-to-cost ratio is used, the SFR program was the most successful.

It is important to recognize that IRS was able to investigate our sample cases, unlike the control group, free of resource constraints. Accordingly, the results from the test illustrate the potential benefits from pursuing these cases should IRS obtain sufficient resources. Table 2.1 outlines these results.

Table 2.1: Results From Three Alternative Methods for Investigating High-Income Nonfilers Compared to IRS' Current Method, Tax Year 1987

Collection method	Percent of returns obtained	Average[a] balance due	Average[b] cost	Balance due to cost ratio
Revenue officers	64	$10,953	$152	$72:1
ACS tax examiners	44	7,943	123	65:1
SFR examiners	40[c]	12,010	7	1,716:1
Control group	35	4,753	79	60:1

[a]Average balance due is taxes, penalties, and interest owed for all delinquent tax years after subtracting withholding and estimated tax payments made before IRS contact. Collection costs have not been deducted from these estimates

[b]Average cost is a GAO estimate, made using IRS data

[c]In addition, IRS made assessments on another 55 percent of the substitute returns for those who did not submit a return. The other 5 percent either filed before notices were sent, were not required to file, or could not be located

To obtain similar benefits from implementing the revenue officer approach nationwide, IRS would need more staff to investigate additional high-income cases. At 1989 staffing levels, many cases sent directly to revenue officers would not be investigated due to lower priorities than other collection cases.

Advantages of Using SFR for High-Income Cases Seem to Outweigh the Disadvantages

Even if IRS investigates more high-income nonfiler cases by separately estimating their yield, the SFR program offers another way to pursue more high-income nonfilers. However, IRS excludes high-income nonfiler cases from SFR. If the SFR program were modified to include high-income cases, the advantages would seem to outweigh the disadvantages. These advantages follow:

- The balance due to cost ratio would far exceed that of the control group ($1,716:$1 versus $60:$1). This difference is largely due to lower costs in SFR. Preparing substitute returns takes far less time than pursuing nonfilers' returns.
- The average balance due would be nearly three times larger than that for the control group ($12,010 versus $4,753) and somewhat larger than that for cases assigned to revenue officers ($12,010 versus $10,953).
- The rate of obtaining delinquent returns would be slightly higher than for the control group (40 percent versus 35 percent).

By modifying the SFR program to include high-income cases, IRS also can avoid issuing refunds to high-income nonfilers for 1 tax year when they also have delinquent returns from other years. Section 6402 of the Internal Revenue Code authorizes IRS to offset refunds from 1 tax year against assessments in other tax years. By preparing substitute returns, IRS can use the assessment from the substitute return to withhold the nonfilers' refunds until the return delinquency for other years is resolved. We believe that this action could encourage nonfilers in the SFR program to submit delinquent returns for all tax years in order to receive their refunds.

We found that IRS issued refunds to about 11 percent of the high-income nonfilers who were in our sample from the three service centers and who had not filed a tax return for other years. For example, a high-income nonfiler for tax year 1987 later filed delinquent 1987 and 1988 returns during November 1989 claiming total refunds of over $7,800. This nonfiler then filed a delinquent return for tax year 1984 during January 1990, showing taxes owed of over $7,000. As of April 1990, the nonfiler still owed this amount. Had IRS assessed the taxes owed for the delinquent 1984 return through SFR, IRS could have used this assessment to offset the taxpayer's 1987 and 1988 refunds.

Despite these advantages, the disadvantages of including high-income cases in SFR need to be carefully considered. These disadvantages follow:

- IRS' Accounts Receivable inventory may increase because some IRS assessments against people who cannot be located have little chance of being collected. Such an increase would artificially boost the size of this inventory, causing IRS to pursue unproductive assessments.
- A substitute return for high-income cases may underestimate the actual tax liability because some income may not be reported to IRS. High-income nonfilers may accept the substitute return rather than file a return on which they would owe more taxes.

In either case, the alternative is worse—allowing high-income cases to escape any IRS tax assessment. IRS had too few revenue officers to pursue nonfilers, or revenue officers pursued them but could not get a return. While using the SFR process may understate the nonfiler's tax liability, it would at least get an assessment on the books. Revenue officers could then attempt to collect the payment. They would be more likely to investigate because an assessment generally gives cases a higher priority than nonfiler cases without an assessment. In contrast, if the case remains indefinitely in the district queue, as many of these cases will, IRS will get no assessment.

Even if IRS discards the $100,000 limitation for SFR cases, many high-income cases still will not be eligible for SFR. We estimate that 46 percent of the high-income cases in our sample would continue to be excluded from the SFR program because they do not pass other restrictions—they have over 30 percent of total income in n nemployee compensation or 40 or more information returns. IRS excludes these cases from SFR because it is concerned that it may understate the tax liability by relying on the income shown on information returns. Modifying these criteria would allow more high-income cases into SFR and allow IRS to create an assessment that otherwise would not exist.

Conclusions

IRS has an ironic imbalance in its nonfiler program that allows wealthy nonfilers to avoid paying their fair share of taxes. High-income nonfilers who do not respond to IRS actions are not assessed a tax as are lower income nonfilers in the SFR program.

IRS could partially correct the imbalance by separately estimating net yields for high-income nonfilers. Doing so would result in revenue officers investigating more unresolved cases. Even so, most unresolved cases would not be investigated because IRS has too few revenue officers. The need to investigate more high-income nonfilers provides a strong argument for increasing IRS' revenue officer staffing.

Another way IRS could correct this imbalance is to modify the SFR program to include high-income nonfiler cases that were not resolved through the notice or ACS stages and will escape any further IRS actions. These include cases that revenue officers (1) will not investigate because of limited staff and (2) will investigate but for which they will not obtain a return.

We do not agree with IRS' reason for excluding complex high-income cases from SFR—fear of understating the tax liability. We believe any tax assessment, even if understated, is better than letting the nonfiler escape all IRS action. For this reason, those high-income nonfiler cases with 30 percent or more nonemployee compensation and 40 or more information returns and that would otherwise escape IRS action should also be sent to SFR. Doing so would allow IRS to resolve all high-income nonfiler cases that would otherwise remain unresolved.

Recommendations

We recommend that the Commissioner of Internal Revenue

- separately estimate net tax yields for high-income nonfiler cases in the formula for screening cases to be investigated by revenue officers and

- modify the SFR program to include high-income nonfiler cases that would otherwise escape IRS action.

IRS' Comments and Our Evaluation

The Commissioner of Internal Revenue commented on a draft of our report in a February 1, 1991, letter (see app. III). He specifically agreed with our recommendation to develop separate estimates of net tax yields for high-income nonfiler cases and to refine the estimates as more recent data becomes available. We support these actions.

The Commissioner also commented on our recommendation to include in SFR all high-income nonfiler cases that would escape IRS actions. He said IRS could do more to resolve high-income nonfiler cases. Specifically, he said that such cases remaining unresolved after Collection's contacts will be referred to the Examination Division. He said Examination will first pursue these cases through correspondence or field examinations and then refer the case to SFR if this initial effort is unsuccessful. While our work shows that the SFR program is an effective way to pursue high-income nonfilers, we believe that these IRS actions, which were not part of our test, may also be effective.

IRS Needs to Check Delinquent Returns From High-Income Nonfilers for Unreported Income and Overstated Deductions

Nearly 12 years after we reported the problem, delinquent returns from nonfilers still do not receive the same level of IRS scrutiny as returns from taxpayers who file on time. IRS checks returns filed on time for unreported income and overstated deductions through computer matching with information returns and through manual screening. However, delinquent returns from high-income nonfilers rarely receive these important checks.

Many delinquent returns that Collection staff obtained from high-income nonfilers had evidence of noncompliance but were not referred to Examination for review. Nearly half of the delinquent returns we asked Examination officials to check had sufficient evidence of unreported income or overstated deductions to justify referral, but only a few of these returns actually had been referred. Moreover, IRS did not computer match delinquent returns with information returns to check for unreported income.

IRS Programs to Detect Noncompliance Do Not Apply to Delinquent Tax Returns

In our 1979 report on IRS' nonfiler program, we found, among other things, that IRS seldom checked delinquent returns it eventually obtained from nonfilers for unreported income.[1] In that report, we estimated that IRS did not detect $14.8 million in delinquent nonfilers' unreported income with potential tax liabilities of $2.2 million in the seven IRS districts reviewed. We recommended that IRS establish a system to check delinquent returns for unreported income.

Although IRS agreed to implement our 1979 recommendation, we found IRS still does not have a reliable system to check delinquent returns for noncompliance. Ironically, returns filed on time usually receive such checks. For example, as discussed in chapter 1, IRS identifies nonfilers and underreporters by matching tax returns with information returns in December of the year the tax return should have been filed. However, IRS does not repeat this computer match for delinquent returns that nonfilers later file as a result of IRS' efforts. By the time delinquent returns arrive, IRS' computer match is covering future tax years. Thus, these delinquent returns, unlike returns filed timely, miss this check for unreported income.

Collection employees also do not appear to screen delinquent returns for unreported income or overstated deductions. For example, by reviewing delinquent returns obtained by tax examiners at ACS or revenue officers

[1] "Who's Not Filing Income Tax Returns" (GGD-79-69)

at district offices, we found that they had not reviewed and referred returns that had indications of unreported income or overstated deductions to Examination officials for more detailed checks. At the service centers, Collection branch officials said they may manually screen delinquent returns that pass through their branches for unreported income.

Collection employees do not screen delinquent returns for two reasons. First, IRS procedures do not require it. In fact, the procedures stipulate that Collection employees will not attempt to audit, examine, or verify the correctness of any return. Rather, Collection's main objective in the nonfiler program is to obtain returns. Second, these employees never get to see many delinquent returns. Service center officials estimated that 40 percent of the delinquent returns bypass the Collection branch because they arrive at service centers without an attached notice that indicates they are delinquent. As a result, they are not referred to the Collection branch.

After delinquent returns are processed through a service center, they are unlikely to be selected for an examination. Although the Examination Division electronically checks delinquent returns for examination potential, IRS officials said few would be selected for examination because returns filed for the current tax year receive greater attention. Further, although Examination staff review delinquent returns obtained through SFR for overstated deductions and unreported income, SFR excludes high-income nonfiler cases, as discussed in chapter 1.

Checking Delinquent Returns for Noncompliance Could Be Productive

Delinquent returns from high-income nonfilers that bypass the various checks for noncompliance still could be examined if Collection employees referred them to the Examination Division. However, we found that they rarely do refer them. While IRS procedures state that these returns may be referred, the procedures neither stress the importance of referrals nor provide criteria to decide which cases to refer. As a result, we found that Collection employees referred to Examination only 4 of the 178 delinquent returns that they obtained from the three service centers.

We asked Examination officials at the service center to review these 178 delinquent returns to get some idea of how many could have been referred because of evidence of unreported income or overstated deductions. These returns represent those obtained through our revenue officer and ACS samples as of April 1990.[2] These Examination officials found evidence of noncompliance on 81 (46 percent) of the 178 returns. Of the 81 returns, 21 (12 percent) had evidence of unreported income and another 60 (34 percent) had evidence of overstated deductions.[3]

To uncover the apparent unreported income, these officials compared income reported on information returns to that reported on delinquent tax returns. For example, they found cases in which a high-income nonfiler had reported

- $116,000 in wages on his delinquent tax return while information returns showed he received about $128,000 in wages—an underreporting of about $12,000 in income—and
- $143,000 in income from medical payments on his delinquent tax return while information reports showed he received $148,000—an underreporting of $5,000 in income.

IRS also could detect potential unreported income if it computer matched delinquent returns from high-income nonfilers with their information returns.

The following examples illustrate what Examination can find if given the opportunity to review delinquent returns from high-income nonfilers for overstated deductions. Examination officials found delinquent returns with deductions of

- $75,000 in mortgage interest, even though the reported income was $101,000 and the information returns showed mortgage interest payments of $58,000 and
- $48,000 in reimbursed employee business expenses from the wage income reported on the delinquent return, even though the Form W-2 showed only $5,000 in such expenses.

Conclusions

IRS does not check all delinquent returns from high-income nonfilers for unreported income or overstated deductions. By not checking delinquent returns, IRS may be giving nonfilers reason to believe that they can cheat

[2] We did not ask Examination officials to do this check for SFR delinquent returns because they were going to have to do a similar check of these returns later.

[3] Examination officials did not estimate the actual amount of noncompliance and resulting tax losses on these 83 cases because they did not have the time, given their workload, to correspond with the nonfilers or examine their tax returns.

on their delinquent returns and not be caught. This is contrary to a sound enforcement strategy and only encourages further noncompliance.

We believe that people who do not comply with one tax law—the filing requirement—are quite likely not to comply with other tax laws. As a result, giving delinquent returns from high-income nonfilers less IRS scrutiny than returns filed on time is illogical. We believe high-income nonfilers should be subject to the same or a higher level of scrutiny as those who file on time.

Since nearly half of the delinquent returns from high-income nonfilers had evidence of noncompliance, we believe all of them should be referred to Examination for a screening for evidence of noncompliance. The recommendation in chapter 2 to allow high-income nonfiler cases to be sent to SFR will, if implemented, increase the number of delinquent returns that are checked. All delinquent returns obtained from SFR are sent to Examination for review. However, delinquent returns obtained through other means, such as revenue officers, also need to be checked.

We also believe that delinquent returns from high-income nonfilers should be computer matched to identify any discrepancies among income and certain deductions that the nonfiler reported. In fact, such matching could be done for all delinquent returns, not just those from high-income nonfilers.

Recommendations

We recommend that the Commissioner of Internal Revenue develop a system to ensure that delinquent returns from high-income nonfilers are checked for unreported income and overstated deductions. This check could be similar to that done during our review in which examiners at the service centers scanned the returns and also computer matched the returns with information returns.

One way to ensure delinquent returns do not bypass these checks would be for IRS to program its computer to identify a delinquent return when received from a high-income nonfiler. Then, IRS could send the delinquent return to Examination for an initial compliance check as is currently done for delinquent returns obtained from SFR. To ensure Examination's limited resources are used efficiently, in-depth examinations should be completed only on those delinquent returns for which strong evidence of noncompliance was found during the check.

IRS' Comments and Our Evaluation

In a February 1, 1991, letter that commented on a draft of our report, the Commissioner of Internal Revenue agreed to develop this system. (See app. III.)

Technical Appendix

The primary focus of our evaluation was an analysis of a randomly selected sample of high-income nonfiler cases. At each of three IRS Service Centers (Austin, Cincinnati, and Fresno), we selected a random sample of 400 nonfiler cases from the universe of cases that remained after IRS sent the nonfilers two delinquency notices. We selected this sample size to provide a confidence level of 95 percent with a precision of plus or minus 5 percent.

Once this overall sample was selected, we randomly assigned about 100 of the 400 cases from each Service Center into each of the following groups: (1) Revenue officers at the district office, (2) tax examiners at Automated Collection Sites, and (3) tax examiners in the Substitute for Return Program. The fourth group served as a control and was allowed to go through the normal three-stage process—notices, ACS, and revenue officers.

Our final sample size was 1,166 because some selected cases were eliminated from our sample for various reasons. For example, IRS lost three cases in one region. In another instance, because the truck carrying completed cases was in an accident, we were unable to reconstruct several cases that were destroyed. Also, six cases were erroneously included in our sample. Table I.1 outlines the overall population and our final samples for each Service Center.

Table I.1: High Income Nonfiler Universe, Sample Population, and Sample Sizes by Service Center, 1987

Service center	Universe after two notices	Sample population	Sample size
Austin	4,193	1,217	383
Cincinnati	2,434	717	389
Fresno	5,494	1,717	394
Total	**12,121**	**3,651**	**1,166**

We developed a data collection instrument that IRS used to record the outcome of these sample cases. IRS officials provided us with the completed data collection instrument and accompanying documentation, such as correspondence from the taxpayer, to support the conclusions reached by the employees working the cases. This documentation provided us with sufficient evidence to assess how well IRS followed up on our sample cases.

Statistical information and confidence intervals for issues we evaluated at the three service centers are shown in table I.2.

Table I.2: Estimates of Key Variables in Sample Cases

Case characteristic	Estimate	95-percent confidence intervals Lower	Upper
Revenue officers			
Return filed	64%	58%	70%
Taxpayer promised to file	9	5	12
Could not locate	10	6	13
Other	18	13	23
ACS Sites			
Return filed	44%	38%	51%
Taxpayer promised to file	6	3	8
Case sent to Queue	37	31	43
Could not locate	6	3	8
Other	7	4	11
Substitute for Return			
Return filed	40%	30%	50%
Substitute prepared	56	46	66
Other	4	1	8
Control Group			
Return filed	35%	29%	40%
Taxpayer did not respond	59	53	64
Other	7	4	9
Average RWMS[a] score	2,967	2,755	3,180
Average assessment—1987			
Control group	$4,781	$1,351	$8,211
All others	$7,890	$5,759	$10,022
Median income (all)	$133,729	[b]	[b]

[a]Resource and Workload Management System

[b]These figures are not available

Appendix II

Profile Data for High-Income Nonfilers

Table II.1: Estimated Income for 1987 High-Income Nonfilers

Income	Percent of nonfilers[a]	Sampling error
$100,000 to $125,000	40	5.7
$125,001 to $150,000	19	4.5
$150,001 to $200,000	15	4.6
$200,001 to $300,000	13	3.8
Over $300,000	11	3.3
Total	**100**	

[a] Does not equal 100 percent due to rounding

Table II.2: Type of Income That High-Income Nonfilers Received

Type of income	Percent of nonfilers	Sampling error
Wages	66	5.5
Nonemployee compensation	60	7.6
Interest or dividends	80	4.7
Other types of income	56	5.7

Table II.3: Predominant Type of Income for High-Income Nonfilers[a]

Type of income	Percent of nonfilers	Sampling error
Wages	55	5.7
Nonemployee compensation	32	5.4
Interest and dividends	3	2.[illegible]
Other income	10	3.4
Total	**100**	

[a] We use "predominant" to mean the income represents more than 50 percent of total income as reported on information returns

Table II.4: Age of High-Income Nonfilers

Age range	Percent of nonfilers	Sampling error
30 and below	7	2.9
31 to 40	21	4.8
41 to 50	38	5.6
51 to 60	22	4.8
Over 60	12	3.8
Total	**100**	

Table II.5: Filing Status of High Income Nonfilers

Filing status	Percent of nonfilers	Sampling error
Single	26	5.[illegible]
Married filing jointly	67	5.5
Married filing separately	1	[a]
Head of household	6	2.8
Total	**100**	

[a] Not statistically significant at the 95-percent confidence level

Table II.6: Results of Checking Delinquent Returns From High Income Nonfilers

Outcome	Percent of nonfilers[a]	Sampling error
Refund	34	4.4
Owed Taxes	56	4.6
No Refund Due or Tax Owed	10	2.8
Total	**100**	

[a] Does not equal 100 percent due to rounding

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: IRS Does Not Investigate Most High Income Nonfilers" and generally agree with the report's recommendations.

We agree that more can be done by the IRS to resolve high income nonfiler cases. Our FY 1991 compliance initiative puts significant emphasis on nonfiler issues. This initiative, now underway, will design a research and data collection methodology that will help us understand the characteristics of the nonfiler population and will assess both the short and long term impact of our efforts. In this regard, we appreciate the work being done by the General Accounting Office (GAO) in this area and will utilize their reviews, along with the findings from our own research efforts, to develop a comprehensive strategy to address nonfiler issues.

In response to GAO's specific recommendations, we plan to change our procedures so that all high income nonfiler cases that are unresolved after collection action will be referred to Examination. These cases will be reviewed for assignment to correspondence or field examination. We believe this process would be more effective in determining the correct amount of unreported income than our Substitute for Returns (SFR) program where we impute income based on income reported on wage and information returns. We plan to review the results of these changes in handling high income nonfilers and give consideration to including them in the Substitute for Returns program where appropriate.

We agree with GAO's recommendation to develop a system to assure that delinquent returns from high income nonfilers are checked for unreported income and overstated deductions. We will change our procedures to clearly state that all delinquent returns should be checked for both unreported income and apparent overstated deductions by Collection employees in service centers as well as district offices, and referred to Examination where appropriate.

-2-

Mr. Richard L. Fogel

In addition, we agree with GAO's recommendation to review separate estimates of potential tax yields for high income nonfilers. We are continually revising our scoring methodology as new information becomes available.

Thank you for the opportunity to review this report. We hope you find these comments useful.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Major Contributors to This Report

General Government Division, Washington, D.C.

Al Stapleton, Assistant Director, Tax Policy and Administration Issues
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IRS' FISCAL YEAR 1992 BUDGET
AND
THE 1991 TAX RETURN FILING SEASON

SUMMARY OF STATEMENT
JENNIE S. STATHIS
DIRECTOR, TAX POLICY AND
ADMINISTRATION ISSUES

IRS' fiscal condition in 1991 appears more stable than it was in fiscal years 1989 and 1990. During those years IRS encountered budget shortfalls of $360 and $465 million, respectively. IRS may have to absorb about $74 million in cost increases for fiscal year 1991. However, IRS will apparently be able to cover most of these costs without having to take the drastic kind of actions it took in 1989 and 1990 when it froze hiring, curtailed promotions, and reduced support services. Because of the more stable fiscal condition this year, it appears that IRS will be able to more fully implement congressionally authorized compliance initiatives--something it was unable to do in fiscal year 1990.

IRS' first budget priority for fiscal year 1992 is full funding for existing staff and related support costs. This accounts for the largest portion of the requested $622 million increase over the authorized level for fiscal year 1991. Compared to past budgets, the fiscal year 1992 budget appears to have been formulated to more accurately reflect on-board labor costs, thus improving the likelihood that new program initiatives will be implemented. However, IRS' ability to achieve some of the $141 million in savings called for in the budget is uncertain.

The most significant compliance initiative proposed for fiscal year 1992 provides an additional $34 million for IRS to collect delinquent accounts. GAO believes this request is reasonable in light of staffing reductions that resulted from past hiring freezes. Another initiative provides for $5.5 million to increase the number of examinations of high dollar tax returns. This increase, however, will only expand audit coverage by .01 percentage point over the fiscal year 1991 level, thus doing little to reverse the steady decline in audit coverage.

GAO has also been monitoring IRS' performance during this year's filing season. On the basis of its analysis of various IRS indicators and its tests of the availability of forms and publications, GAO believes that this year's filing season is proceeding successfully, continuing a recent trend. For example, the current accuracy rate for telephone assistance is 80 percent. The one area that was a specific problem last year--taxpayers' ability to get through to IRS--is still a problem. As of March 9, 1991 IRS answered 9.6 million (42 percent) of the 22.7 million calls for assistance. That answer rate is better than last year's but well below the 61 percent answer rate for the 1989 filing season.

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-241961

March 13, 1991

The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Internal Revenue Service's program for detecting and pursuing individuals who have an income of over $100,000 and who fail to file required federal tax returns. It shows that the Service needs to improve this program to make sure that the nation's voluntary tax assessment system remains strong.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from the date of issuance. At that time we will send copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

Major contributors to this report are listed in appendix III. If you have any questions, please call me on (202) 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director
Tax Policy and
Administration Issues

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its inquiry into IRS' current fiscal condition, IRS' budget request for fiscal year 1992, and the status of the 1991 filing season. My testimony makes the following points:

-- IRS' fiscal condition in 1991 appears more stable than had been the case the prior 2 years. There are some unanticipated costs that IRS is going to have to absorb this year, but not of the magnitude that existed in 1989 and 1990.

-- Because of the more stable fiscal condition this year, it appears that IRS will be able to do something that it was unable to do in 1990--more fully implement congressionally-authorized compliance initiatives.

-- IRS' budget request for fiscal year 1992 has been formulated in a way that seems to do a better job of fully funding IRS' current operations, which portends well for improved fiscal stability in 1992.

-- The most significant compliance program increase in the fiscal year 1992 budget request involves additional staff to collect delinquent accounts. That request seems reasonable, especially considering the negative effects of hiring freezes in 1989 and 1990. We continue to believe, however, that IRS needs better information for use in managing its collection activities.

-- There are certain aspects of IRS' fiscal year 1992 budget request, in addition to the tax system modernization issues that will be discussed by our Information Management and Technology Division, that we believe the Subcommittee needs to consider during its deliberations. Those deal with the acceptable level of taxpayer telephone service and our continuing concerns about the level of audit coverage.

-- Based on the various IRS indicators we have been monitoring and our own tests of the availability of forms and publications, this year's filing season has continued the recent trend of successes. This year, for example, IRS statistics show that its assistors have responded accurately to 81 percent of IRS' test questions, compared to 76 percent last year. There is conflicting evidence, however, as to how successfully taxpayers may be getting through to IRS this year compared to last.

FISCAL YEAR 1991--FINANCIAL STABILITY

We told the Subcommittee last year[1] that the most important question to be answered in assessing IRS' fiscal year 1991 budget request was whether it provided a base for stabilizing what had been an unstable fiscal environment. Because of that instability, IRS had to freeze hiring, curtail promotions, and cut back support services. One result of those actions was that new compliance initiatives that Congress had authorized for fiscal year 1990 could not be fully implemented.

Because of changes IRS made in preparing the fiscal year 1991 budget, we told the Subcommittee last year that the prospects for an improved fiscal condition in 1991 appeared good. We cautioned that several factors could adversely affect IRS' fiscal prospects, most notably pay reform and anticipated postal rate increases. We also questioned IRS' ability to achieve certain savings.

Before its final appropriation was passed, IRS officials met with congressional staff to discuss reallocations that were needed to the President's 1991 budget to deal with potential shortfall conditions, including those we discussed in last year's testimony. As a result of the reallocations, IRS' appropriation

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[1] IRS' Budget Request for Fiscal Year 1991 and Status of the 1990 Tax Return Filing Season (GAO/T-GGD-90-26, March 22, 1990).

covered most of those conditions. According to IRS Finance Division officials, however, IRS may still encounter a shortfall of about $74 million which consists of (1) $23 million for telecommunications; (2) $11 million resulting from the inability to achieve FTS-2000 savings called for the 1991 budget; (3) almost $7 million for postage for other Treasury agencies; (4) an additional $18 million for geographic pay; and (5) $15 million to purchase rather than lease certain computer equipment.

IRS plans to absorb some of the shortfall with funds that were originally authorized to be spent on compliance initiatives. Not all of these funds will be used for the initiatives, in part, because as discussed next, IRS was not able to hire the new staff as soon as anticipated.

Status of fiscal year 1991 compliance initiatives

IRS' fiscal year 1991 budget provided for compliance initiatives that IRS said would raise about $0.5 billion in additional revenue in fiscal year 1991 and $5.7 billion through fiscal year 1995. Congress appropriated $191 million and 3,476 additional staff years for those initiatives. Because of budget reallocations and hiring delays, IRS now estimates that these initiatives will raise about $230 million in fiscal year 1991--less than half the original projection.

IRS based the original revenue projections on the assumption that it would begin hiring the additional staff on October 1, 1990. Because IRS did not receive its fiscal year 1991 appropriation until October 27, 1990, it did not begin hiring until early January 1991. IRS hopes to fully staff the initiatives by the end of fiscal year 1991. Even with this hiring, IRS' total enforcement staffing will be well below that realized in fiscal year 1988. For example, IRS' budget documents show that, on the average, IRS had 16,558 revenue agents in fiscal year 1988 compared to the 15,680 revenue agents that are expected for fiscal year 1991.

IRS also restructured the 1991 initiatives by dropping two service center initiatives and adding another collection initiative. One of the initiatives dropped was aimed at increasing correspondence audits and other service center contacts with taxpayers about problems with their returns. The other initiative sought to identify noncustodial parents who incorrectly claim their child's exemption on their federal tax returns. In lieu of these two initiatives, IRS added an initiative that will attempt to secure an additional 142,000 delinquent returns between January 1, 1991, and September 30, 1991. This initiative was one of six that had been authorized by Congress for fiscal year 1990 but were not implemented that year because IRS had to reallocate the funds to cover unbudgeted cost increases. With the new mix of compliance initiatives for fiscal year 1991, IRS hopes to achieve about $6.2 billion in additional revenue by fiscal year 1995.

MAINTAINING LABOR AND SUPPORT COSTS ACCOUNTS FOR LARGEST PORTION OF FISCAL YEAR 1992 BUDGET INCREASE

Now turning to the fiscal year 1992 budget. The large budget shortfalls IRS experienced in fiscal years 1989 and 1990 were attributed, in part, to underestimating base labor and support requirements. Thus, IRS' first budget priority for 1992 is full funding for existing staff and related support costs. This accounts for about 51 percent of the fiscal year 1992 increase over the 1991 authorized level.

The budget totals $6.7 billion and provides for 116,585 average positions, a net increase of $622 million (10 percent) and 963 average positions (1 percent) over the authorized levels for fiscal year 1991. The $622 million increase is a net of $763 million in increases and $141 million in decreases. The increases include

-- $388 million for labor and support costs;

-- $256 million for information systems, of which $162 million is for IRS' modernization effort;

-- $57 million for new compliance and management initiatives, of which $34 million is to increase the collection of delinquent accounts;

-- $46 million to annualize the costs associated with the 1991 compliance initiatives;

-- $16 million in workload increases, the bulk of which will be used to process an additional 2.6 million tax returns.

The $141 million decrease is for nonrecurring costs and expected savings, which according to returns processing officials, include savings of $17 million from electronic filing and $15 million from the on-line-entity system. The on-line entity system is one of the projects that will be discussed as part of our Information Management and Technology Division's testimony.

We believe that the 1992 budget is cast in a way that continues the positive steps taken last year to more accurately reflect on-board labor costs and thus improves the chances that new program initiatives will be implemented. For example, compared to past budgets that required IRS to absorb at least some of the federal pay increase, the fiscal year 1992 budget provides funding for all of the anticipated 4.2 percent pay increase. It also more realistically assumes that revenue initiative staff will be on board mid-way through the fiscal year rather than at the start of the year.

Some of the $141 million in decreases may not be realistic. For example, the returns processing function is being cut about 900 average positions due to the expected savings from on-line entity systems and electronic filing. According to returns processing officials, to realize the estimated savings for electronic filing, 25 million returns would have to be filed electronically in fiscal year 1992. IRS currently estimates that it will receive 6.2 million electronically filed returns this year and is expecting 8.2 million in 1992.

In addition, the 1992 budget was adjusted for certain costs that should not recur--for example, a $15 million computer purchase budgeted for fiscal year 1991. Such adjustments assume IRS will spend 1991 funds for their intended purpose and not divert them to other areas.

Proposed increase to collect delinquent accounts

The largest compliance program increase in the fiscal year 1992 budget is for 671 staff years and $34 million to enable IRS to collect more delinquent accounts. As we have testified in the past, IRS does not have the necessary information to determine how many staff it needs to collect its accounts receivable.

Considering the size of the accounts receivable inventory, however, we believe the authorization of additional staff in fiscal year 1992 is appropriate--especially in light of the reduced staffing levels that resulted from 2 years of hiring freezes. For example, the average number of revenue officers in the collection activity had decreased from 8,238 in fiscal year 1988 to 7,601 in fiscal year 1990. In the longer term, IRS needs to change the way it carries out its collection activities based on sound financial and management information.

IRS has taken some steps to develop better information--information that can be used to obtain meaningful collection trends. We used the information in work we are doing at the request of the Chairman. We analyzed the limited historical data IRS now has available to project the ultimate disposition of the almost $93 billion accounts receivable balance as of September 30, 1990. The analysis shows that, if IRS continues to do business as usual, it will

-- collect only $23 billion, or less than one-fourth of the accounts receivable balance,

-- abate at least $24 billion, and

-- write off nearly $46 billion due to the expiration of the 10-year statutory collection period.

These results should not be viewed as an indicator of IRS' overall collection effectiveness because IRS collects many new receivables before they become part of the year-end inventory. The $23 billion collection estimate also needs to be compared with the portion of the receivables that could be collected. Clearly, for example, most of the $24 billion to be abated would represent amounts that should not have been included in the inventory. Little is known, on the other hand, about the characteristics and validity of the $46 billion we estimate will be written off. That type of information is critical to developing a collection strategy.

Issues to be considered in assessing the adequacy of the fiscal year 1992 budget

We will now discuss two issues that the Subcommittee may want to consider during its debate on the adequacy of IRS' proposed budget. We raise these issues to clarify what the proposed budget will provide, not necessarily to advocate additional funding. We realize that the amount of "discretionary funding" is limited and that funding decisions will be difficult.

Level of toll-free telephone service

First is the question of whether the 74 percent level of toll-free telephone service provided for in the budget is acceptable. IRS defines the level of service as the number of telephone calls IRS answers relative to its estimate of the number of persons calling for assistance. The level proposed for fiscal year 1992 is slightly below the 76 percent level that IRS expects to provide in fiscal year 1991. As we will discuss later, this year's level of service statistic translates into a 42 percent answer rate.

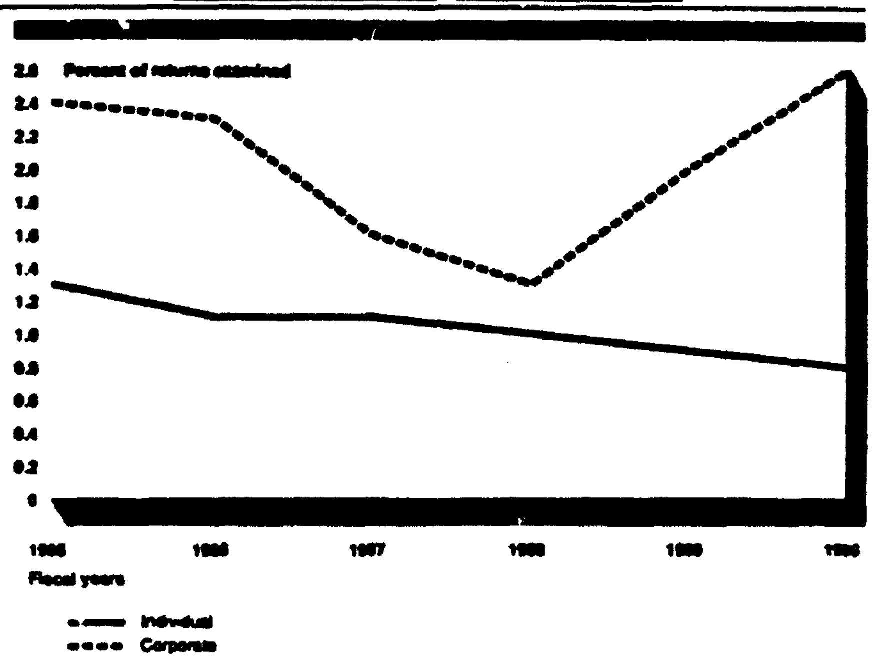
IRS originally sought funding to provide an 85 percent level of service in fiscal year 1992. During the budget formulation process, however, the Treasury Department concluded that "there appears to be an acceptable congressional tolerance of a 75 percent service level in the current budget environment." We do not know what level of service is acceptable to Congress in general or to the Subcommittee in particular. We believe that the acceptability of a particular level of service would depend in a large part on the quality of that service. As we will discuss later, the quality of IRS' service has been improving.

Audit coverage

The fiscal year 1992 budget proposes an increase of 86 examination staff years to enable IRS to increase the number of examinations of high dollar tax returns. This increase, however, will only expand audit coverage by .01 percentage point over the fiscal year 1991 level, thus doing little to reverse the steady decline in audit coverage. Overall, audit coverage has declined from 1.3 percent in fiscal year 1985 to 0.84 percent in fiscal year 1990 and is expected to increase to 0.91 percent in fiscal year 1992. Figure 1 shows the trend in audit coverage since 1985 for individual and corporate returns.

Figure 1:

Individual and Corporate Audit Coverage, Fiscal Years 1985 Through 1990



Source: IRS Annual Reports

IRS has said that audit coverage does not present a complete picture of enforcement presence, that the decline in audit coverage for individual taxpayers does not take into account contacts through the Information Returns Program (IRP).

IRP, however, has some limitations. It can check only the income and few deductions for which IRS receives information returns. Also, over half of the potential underreporter cases identified by IRP are not productive because of various errors made by taxpayers and employers. Finally, there is no IRP for corporations. In March 1987, GAO testified on the merits of establishing a business information returns program.[2] While IRP is a valuable supplement to IRS' audit presence, we believe the threat of an audit is a key component to maintaining voluntary compliance. We are concerned that the decline in audit coverage will encourage more people to play the "audit lottery".

THE 1991 FILING SEASON

This year's filing season, like those of the past few years, appears to be proceeding successfully. We assessed various IRS indicators relating to taxpayer service, forms distribution, and returns processing and did our test of the availability of forms and publications. We saw little to give us cause for concern.

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[2]The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, March 17, 1987).

The one area that was a specific problem last year--taxpayers' ability to get through to IRS over the telephone--is still a concern, although performance appears to have improved somewhat compared to last year.

Telephone assistance

IRS' telephone assistors have continued to improve the accuracy of their answers to test tax law questions this year. It is unclear, however, whether service availability is better or worse than last year--and that is a concern.

Telephone assistors are answering test tax law questions accurately about 81 percent of the time, according to IRS' Integrated Test Call Survey System (ITCSS). This is higher than the 76 percent accuracy rate at about the same time last year and compares favorably with the 1989 filing season accuracy rate of 63 percent. Although still short of the 85 percent goal IRS set for this year, the upward trend is encouraging.

We monitored 327 test calls made by IRS between March 4 and March 15. Our scores of those calls agreed with IRS scores about 95 percent of the time. Because of the consistency of these results, we believe that the 85 percent accuracy rate IRS reported for each of the 2 weeks is reliable. The calls we scored also indicated an accuracy rate of 85 percent. We will continue to monitor test calls throughout the filing season and will provide the results to the Subcommittee for the hearing record.

We believe that IRS' improvement in test call accuracy over the past 2 years stems primarily from (1) continuing top-to-bottom management emphasis and involvement and (2) development and implementation of standards for evaluating and improving the telephone assistance program. The Commissioner has continued to emphasize improving assistor accuracy and our visits to the field indicate that this emphasis is clearly understood and is being acted on by top field managers, supervisors, and assistors on the line.

Challenges remain, however, particularly in the areas of stabilizing the assistor work force, strengthening training, and incorporating automation into the program.

The absence of agreed-upon standards for evaluating and improving the telephone assistance program has been a matter of concern to us and to IRS for several years. We believe this problem has been overcome. First, the test that GAO and IRS have worked together to develop has established a nationwide standard for assessing call site performance. The results of the test, along with other data, are being used by IRS managers to make resource and workload allocation decisions and to identify and correct problems in answering taxpayers' questions. The test has also created a healthy competition among the call sites, which we and IRS officials believe is contributing to better performance.

Second, IRS has completed and issued a single nationwide probe and response guide to aid assistors in probing to obtain all the facts needed about a taxpayer's situation before attempting to answer the question. The use of this guide by assistors and supervisors has been made mandatory, and training on how to use it has now been provided. We believe that the development and nationwide use of this guide has already contributed a great deal to IRS' improved accuracy. The guide contains uniform standards for acceptable responses. Thus, it is both a standard and a tool that provides a framework for training, a basis for measuring assistor performance, and a means for identifying and correcting performance problems.

Much has been accomplished in the past few years, but much remains to be done to ensure that taxpayers receive accurate and timely assistance.

IRS continues to experience heavy attrition in its assistor work force, particularly among seasonal employees. IRS estimates it lost about 1,230 seasonal employees during fiscal year 1990. It is working to increase the percentage of permanent employees, which should reduce turnover and, if successful, reduce the cost of training new employees each year.

GAO and IRS have both studied assistor training during the past year and concluded that the training had improved, but further improvements were needed. We are preparing a report that recommends, for example, that IRS reduce the number of "yes" or "no" questions on classroom tax-law tests and substitute questions to test students' probing skills. We also are recommending that IRS develop an experienced training corps to revise the course material. Currently, revisions to the previous year's training materials are made by staff that have little or no experience in course development. We will continue to monitor IRS' efforts to improve assistor training.

Another important tool intended to improve telephone assistors' performance is the Taxpayer Service Expert Assistance System. This automated system, now incorporated into a broader system called the Taxpayer Service Integrated System (TSIS), was first tested during the 1990 filing season at the Boston call site. As the Subcommittee requested, we have reviewed IRS' progress with TSIS since that time.

IRS needs better information before it can justify investing in TSIS, including information on the specific benefits of installing it and on whether non-automation alternatives would be more cost effective.

The Boston call site test was inconclusive. The accuracy of responses to taxpayer questions improved at Boston by about 21 percentage points, but other call sites also improved substantially without the automated system. For example, during the 1990 filing season, 23 call sites improved accuracy by more than 10 percentage points through management initiatives and 3 of the 23 sites increased accuracy more than the Boston site.

IRS is testing TSIS again during the 1991 filing season. From these tests it had hoped to get enough information to decide whether to begin installing TSIS at all 32 call sites. The tests are, however, either flawed or limited in ways that will result in information that will not provide an adequate basis for IRS to decide how to proceed. Essentially, the tests are not structured to isolate and measure the system's results separate from other non-automation changes.

Because of concerns similar to ours, the Office of Management and Budget denied IRS' fiscal year 1992 budget request of $41 million for TSIS. Consequently, IRS recently decided to continue testing during fiscal year 1992, instead of beginning to install TSIS. We endorse this decision and recommend that these tests be constructed to measure specific benefits of the system and that

IRS evaluate at each site whether non-automation alternatives are more cost effective than TSIS.

There is conflicting information as to how successfully taxpayers may be getting through to IRS this year compared to last. Using IRS data on the number of calls received and answered, we computed an answer rate of 42 percent as of March 9, 1991, compared to 34 percent last year. ITCSS statistics, however, show that for the week ended March 16, IRS' test callers were able to get through on their first call only 38 percent of the time, which, on its face, looks like a considerable drop off in performance from last year. At the same time last year, IRS' test callers got through 47 percent of the time on their first attempt.

Fewer taxpayers are calling IRS' toll-free lines and IRS added resources to increase the availability of telephone service. As of March 9, 1991, IRS statistics show that taxpayer demand for telephone service was running 7 percent below the demand IRS expected for 1991 and 4 percent below actual 1990 demand. In part because IRS estimated that demand for toll-free telephone assistance would increase 10 percent between fiscal years 1990 and 1991, it purchased new telephone equipment, increased the number of new phone lines at its toll-free sites by 12 percent, and increased the number of telephone assistor staff hours by almost 7 percent.

We asked IRS taxpayer service officials why, in light of the lower-than-expected demand this year and the additional resources, telephone availability was not any better. They said that the toll-free sites were not using all the allocated staff so as to be able to meet a pick-up in demand. IRS staffing levels bear this out. As of March 9, 1991, IRS had about 6 percent fewer staff devoted to taxpayer service functions than at the same time in 1990. The officials said they were encouraging the toll-free sites to increase their service levels, which should make it easier for taxpayers to reach IRS in the coming weeks.

Forms and publications

In light of IRS' success in improving the availability of tax materials in recent years, we reduced the number of walk-in site visits and mail and phone orders made to monitor the 1991 filing season. Our visits to walk-in sites and the results from our mail and phone orders indicate that tax materials are readily available to taxpayers this year.

Between February 21 and March 1, 1991, we visited 10 walk-in sites in 6 states and the District of Columbia to check on the availability of 87 forms and publications that all walk-in sites are required to stock. Six sites had all the required items, 3 sites were missing 1 item each, and 1 site was missing 2 items. This compares favorably with last year's visits to 13 sites between January 22 and February 26 when we checked the availability of 82 mandatory items and found that 1 site was missing 8 items, 2 sites were missing 6 items, 9 sites were missing between 1 and 5 items, and 1 site was missing nothing.

Taxpayers can also order tax materials by mail or phone from one of IRS' three distribution centers. This year, we ordered forms and publications from two centers. Between February 12 and February 28, we placed 22 mail and phone orders. Each order was for 4 items selected randomly from IRS' list of 87 mandatory items. As of March 15, we had received 82, or 93 percent, of the 88 items ordered. We received 73 percent of our mail-ordered items and 100 percent of our phone-ordered items within the 2 weeks that IRS tells taxpayers to expect delivery. We received 88 percent of the mail-ordered items in 16 days.

IRS' own tests of the availability of tax materials show somewhat mixed results. This year, IRS's objective is to accurately process at least 94 percent of its phone and mail orders. In order to determine whether it is meeting this objective, IRS staff have analyzed 846 test orders made between November 26, 1990, and February 23, 1991. Those results show that IRS accurately filled 85 percent of its phone orders and 95 percent of its mail orders. An IRS official in the forms and publications distribution area explained that most of the errors on the phone orders were caused by sending too many or too few of the requested items.

As was the case with taxpayers seeking answers to tax law questions, taxpayers attempting to order tax materials by phone are probably having less trouble reaching IRS this year. As of March 9, 1991, according to IRS' statistics, the three distribution centers had answered about 2.9 million or 54 percent of taxpayers' calls, compared to 2.7 million or 46 percent of the calls at the same time last year.

Returns processing

As of March 9, 1991, according to various IRS indicators, IRS has done a good job processing tax returns and managing service center inventories. Two patterns have emerged. More taxpayers are filing electronically and more taxpayers who file paper returns are using form 1040A.

As of March 9, 1991, IRS had received 45.0 million tax returns, about the same number as this time last year, and had processed about 72 percent of these receipts, down about 1 percentage point from last year.

More taxpayers are filing electronically this year. As of March 9, 1991, IRS had received 5.9 million electronically filed returns--81 percent more than last year. IRS believes that electronic filing offers considerable advantages to taxpayers and IRS in the form of faster refunds and fewer processing errors. We are currently reviewing IRS' strategies to increase the number of electronic filers.

Another change this year is that more taxpayers are using form 1040A to file their returns. This is occurring because IRS revised the form to allow taxpayers to report pension income. IRS estimates that about 4.5 million more taxpayers will be able to reduce their paperwork burden by filing form 1040A. Through March 9, 1991, IRS statistics show that 952,000 more taxpayers have filed 1040A, about 9 percent more than last year.

Over the last several years, IRS has begun to establish specific objectives for service centers to use in managing their inventories. These inventories, which can be thought of as "things gone wrong" or needing special attention, have steadily decreased over this period. Those decreases have continued in 1991. As of March 9, decreases for six of the seven inventories ranged from 1.6 percent to 33.1 percent below 1990 levels. The seventh inventory--rejects--had increased 16.2 percent, which IRS attributed to a procedural change.

Errors made in processing tax returns

In the past, we have cited IRS statistics on the percentage of returns involving errors made either by the taxpayer in filling out the return or by IRS in processing it and have pointed out that many of the same types of errors are made year after year. In 1990, IRS began studying several types of recurring errors in the hopes of having some solutions in place for the 1991 filing season. Included among those studies were such problem areas as the earned income credit and the transcription of incorrect social security numbers during processing. As of February 1991, most of those studies had been completed. IRS says that it has already implemented some of the solutions recommended by the study teams and is considering further actions for implementation in 1992. The solutions already implemented generally involved increased training, changes to the Internal Revenue Manual, and changes to training materials. Other changes that require more study or that cannot be effectively implemented until 1992 involve such things as changes to forms.

We do not know whether the implemented changes have had any effect on reducing the incidence of errors this year. IRS' list of the most frequently-occurring errors this filing season, however, still includes several that have made the list in past years. For example, IRS data entry staff are not properly recording dependent designation status for tax purposes. Additionally, taxpayers continue to experience problems in computing and correctly claiming the earned income credit.

In a report we are issuing today to the Subcommittee, we also raise questions about the validity of IRS' error rate data as an indicator of its returns processing performance.[3] We question that data because it includes errors made by taxpayers and counts as errors things that are not errors. We are recommending, among other things, that IRS use an indicator to measure returns processing quality that specifically identifies the extent to which errors are being made by service center staff in processing the returns. That report also includes information on the quality of (1) service center correspondence with taxpayers about adjustments to their accounts and (2) notices IRS sends taxpayers informing them of changes made to their returns during processing.

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That concludes my prepared statement. My colleagues and I will be happy to respond to any questions.

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[3]Tax Administration: IRS Needs to Improve Certain Measures of Service Center Quality (GAO/GGD-91-66, March 20, 1991).

Ordering Information

Copies of GAO reports cited in this statement are available upon request. The first five copies of any GAO report are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

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